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SUBJECT: Factories and Money: Visit by Federal Reserve
Senior Economist John Schindler

Reference: 05 GUANGZHOU 23995

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¶1. (SBU) SUMMARY: Guangdong is not reaping long-term benefits from the majority of its manufacturers because they are processing and assembly plants, according to Guangzhou academics. China should move away from this type of manufacturing and focus instead on high value-added and high-technology industries. This is already happening in the Pearl River Delta, because of higher costs for land and labor and the appreciating RMB. The academics are also calling for the preferential tax rates for foreign investors to be eliminated. The vice president of a state-owned import/export company said his company is barely surviving, and a three-percent appreciation of the RMB would drive it into bankruptcy. Separately, a Bank of America representative discussed the company's business strategy in China, and a Fedex representative said some Chinese officials are beginning to realize that customer service is key. END SUMMARY

¶2. (U) During a visit to Guangzhou March 28-30, Federal Reserve Senior Economist John Schindler met with two economics professors, a government trade consultant, and representatives from Bank of America and Fedex. Interlocutors discussed manufacturing, trade, the exchange rate, and the Chinese government's long-term approach to dealing with these issues.

Be Gone, Assembly Processing

¶3. (SBU) The Guangdong manufacturing industry is overly reliant on the processing and assembly (P&A) sector, according to Huang Jingbo, Dean of Zhongshan University's Economics Department. Two-thirds of Guangdong's manufacturing industry is P&A, compared to 55 percent nationally. In a separate meeting, Chen Lei, Deputy Director of the Guangdong WTO Affairs Consultation Service Center, estimated that 80 percent of Guangdong trade is in P&A components and goods. Both observers said P&A manufacturing is not a good investment for long-term growth -- it has low profit margins, offers the lowest wages, and involves very little technology transfer. Almost all P&A

manufacturing is for export, and most of the investment comes from foreign (especially Hong Kong) companies. China runs a deficit in ordinary trade, but a surplus in P&A trade.

¶4. (SBU) The P&A sector is beginning to move out of Guangdong because of rising wages and energy prices in the Pearl River Delta (PRD), according to Chen. He said RMB 6 billion (USD 750 million) in FDI is relocating out of Dongguan -- a manufacturing center between Guangzhou and Hong Kong -- every year. These factories are going to other provinces like Zhejiang and Jiangsu, or to other countries like Vietnam and Laos, because of increasing costs and lower profits. They are being replaced by higher value-added manufacturing. Provincial and municipal authorities encourage this trend because they would like to see a higher level of manufacturing as well as more trade in services. Chen said Chinese officials have noted that India is successfully encouraging service sector companies by reducing their taxes.

Slowing Export-Led Growth

¶5. (SBU) China's government would like to its slow export-led growth in part to reduce China's reliance on imported commodities, according to Shen Boming, economics professor at the Guangdong University of Foreign Studies. Chen, from the WTO Center, said Chinese leaders are serious about this policy shift, citing several examples: GDP growth is no longer the sole criteria in evaluating an official's effectiveness, MOFCOM is increasingly concerned with issues beyond FDI growth, and more competition is being encouraged in the import industry. The government would also like to

increase imports of high-tech products, but strict U.S. regulations mean that "we can only buy airplanes."

¶6. (SBU) China's export growth will likely slow by itself because China has already implemented many of its WTO-related tariff reductions. Rising wages and land prices in dense manufacturing areas will also increase overall production costs. China's low-end manufacturers are finding themselves in a bind, as they are reluctant to raise prices but face bankruptcy if they do not. Shen said consolidation in the industry is already happening -- particularly in the textile and clothing industries -- but is not yet widespread. The appreciating RMB has also eliminated some domestic exporters that have thin profit margins. Despite all of these factors, Shen said he expects China's growth rate to be between eight and nine percent in 2006.

More Tax Equality!

¶7. (SBU) Huang said academics began debating in the 1990s the utility of China's preferential tax treatment for foreign investors. In the last few years, momentum has been building to unify foreign and domestic tax rates. Both Huang and Shen believe preferential tax policies for foreigners should be scrapped. Huang said domestic companies abuse the rules with "flow back" investments -- sending their money abroad and then back (see Reftel). When asked, Huang noted he has not seen any studies on the effect a unified tax rate would have on China's trade. Shen said the government is concerned that such a change would reduce FDI inflow, and thus slow the country's employment growth.

A Struggling State-Owned Enterprise

¶8. (SBU) State-owned Guangdong Machinery Import and Export Co. (GMG) is struggling to adapt to China's increasingly competitive business environment. A decade ago, GMG was one of the few companies in Guangdong that had an export

license. Company employees sat in their offices and waited for customers to come to them, said Chen Zhicheng, GMG's vice president. The situation is very different now, with export licenses commonplace, and GMG cut off from government subsidies or preferential loans. Chen said if the company does not make a profit, it would go bankrupt like any private company. He complained that his company is now working at a disadvantage, however, because it pays its taxes in full, treats its workers well (and cannot easily fire them), and is burdened with prior pension obligations. In addition, GMG must hand over some of its profits to its holding company under the Guangdong Department of Foreign Trade and Economic Cooperation.

¶9. (SBU) GMG primarily exports and imports machinery products for customers and does very little manufacturing, in essence operating as a logistics company. It also provides credit for small purchasers. GMG exported USD 240 million in goods in 2005, including shipping-container vessels, gardening tools, machinery parts, pumps, lighting products, and MP3 players. It imported USD $230 million in goods, primarily telecom, medical, and power plant equipment. Chen said GMG is making a profit, but not a large one. He blamed rising wages, more expensive raw materials (e.g. lead for batteries that the company manufactures), and the rising value of the RMB as cutting into the company's profits. When asked how far the RMB could appreciate before the company would go bankrupt, he said approximately three percent (an indication of the company's profit margin).

Bank of America: Waiting for the RMB Door to Open
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¶10. (SBU) Bank of America (BOA) conducts three types of business in China: dealings with financial institutions, foreign exchange settlement, and trade financing for exporters, according to Wu Ke Wei, vice president for the bank's South China financial institutions group. Wu said they plan to add a corporate and investment management department as well as a cash management department in the

near future. He differentiated BOA's business strategy from Citibank's: BOA concentrates on enterprise business while Citibank deals more with financial institutions. When asked about plans to open retail outlets, Wu said BOA agreed not to do so for three years as part of its deal to purchase a nine-percent stake in China Construction Bank (CCB) in 2005. When asked about BOA's relationship with CCB, Wu said BOA is not involved in CCB's management, but does provide training on issues such as retail business to branch-level offices.

¶11. (SBU) Julia Yu, branch manager for Guangzhou, said she expects China will allow foreign banks to conduct RMB transactions before December 2006, and BOA has already prepared its application. Yu said Chinese regulators recently introduced stricter requirements for foreign banks to accept imported foreign exchange, including extensive checks of supporting documents (this is likely due to concerns about currency speculators). Simultaneously, China's rules on foreign exchange leaving China have loosened, and outward FDI has increased as a result. Regarding the appreciation of the RMB since July 2005, Wu said he has been surprised to see more clients request to change foreign exchange into RMB. Some clients have complained that they have lost money as a result of the appreciation, and others have shown an interest in hedge investments.

Fedex Finds Better Access

¶12. (SBU) Alex Yim, managing director and chief representative for Fedex in South China, said he has seen Chinese officials adopt a more customer friendly attitude in

recent years. Fedex established its Asia/Pacific hub in Guangzhou in 2005, but it basically serves as a global hub because of flight patterns. Fedex has a good working relationship with Guangdong Customs, and Yim described the director general as forward-thinking and pro-Western. Guangdong Customs has asked Fedex for input as it drafts new customs clearance procedures, which would allow clearance for cargo at any entry point and simplify the value-based categorization system. Yim said he was told that this draft would serve as a blueprint for national regulations. Separately, Yim said the Air Traffic Bureau (under CAAC) invited him recently to serve on a consultation board comprised largely of representatives from Chinese companies. He was also asked by the Logistics Institute of Jiaotong University to serve as a visiting professor, responsible for two or three seminars a year. This would not only allow him to train the next generation of logistics professionals, but would also give him a different "hat" to wear in an official capacity.

Comment: Time to Shape Up

¶13. (SBU) The honeymoon between South China and P&A plants appears to be over, and the government is looking for higher value-added operations to take their place. Dongguan is a good example of this phenomenon, as the city -- which is an hour's drive from the Hong Kong border -- has literally run out of land and is reportedly no longer approving permits for low value-added or polluting manufacturers. Many relocate to inland areas within Guangdong or to other provinces, where local governments are eager for investment of any kind. With a profit margin somewhere around three percent, profit-sharing and pension commitments could mean the end for state-owned enterprises in situations similar to GMG's. However, with the right vision and leadership, such companies may be able to learn to adapt. GMG, for example, has the potential to successfully transform itself into a reliable logistics provider. Separately, the Air Traffic Bureau's invitation to Fedex's Yim to serve as a consultant, as well as Custom's cooperation in drafting new regulations, are signs of a Chinese bureaucracy that recognizes the long-term benefits of good customer service.

¶14. (U) Mr. Schindler has cleared this cable.

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